

## Create a Custom RTF Royalty Trust Fund Looks Timely

### Summary and Recommendation

We recommend that an interested investor create a custom RTF because five characteristics of oil and gas royalty trusts support the case that current investment may be timely. We create an illustrative Royalty Trust Fund sized for the maximum total of nine approximately equal positions which would keep the RTF below 5% of the units outstanding for the smallest trust (see table [The \\$20 Million RTF](#) below). Our first reason for timeliness is the steep decline in stock price suffered by six of the nine stocks in 2012. Second, the RTF group is 59% concentrated on natural gas whose price is rising in a defined uptrend from a decadal low. Third, stock price declines have been exaggerated by the required use of cash accounting, which lags real time and expenses all outlays when incurred. Fourth, estimated 8.3% cash income for the next year is high and may have tax advantages. Fifth, risks are mitigated with no debt, low operating leverage for top line payers and shareholder control of reinvestment. After discussing the common features, we add short statements on each stock in order from lowest to highest McDep Ratio.

The \$20 Million RTF (Royalty Trust Fund)										
		Price <i>Symbol/Rating</i>	Fund <i>(USS/sh)</i>	Shares <i>or Units</i>	Market <i>Value</i>	Top <i>Line</i>	PV(%) <i>Nat</i>	Dist. <i>NTM</i>	Dist. <i>Yield</i>	McDep <i>Ratio</i>
	B = Buy	4-Oct					Gas	Oil	(\$/un)	(%)
	CB (see below)		2012	(thous.)	(\$mm)	(%)				
Freehold Royalties Ltd.		FRHLF	20.49	110	2.3	71	16	84	1.71	8.3
Enduro Royalty Trust (40%)		NDRO	18.88	130	2.5	0	39	61	1.80	9.5
Dorchester Minerals, L.P.		DMLP CB	22.65	100	2.3	77	57	43	2.15	9.5
Sabine Royalty Trust		SBR	51.90	50	2.6	100	55	45	3.97	7.6
Permian Basin RT		PBT	15.03	150	2.3	47	37	63	1.09	7.3
Cross Timbers Royalty Trust		CRT	31.70	70	2.2	78	70	30	2.70	8.5
San Juan Basin Royalty Trust		SJT CB	14.13	160	2.3	0	100	-	1.20	8.5
Mesa RoyaltyTrust		MTR	25.67	90	2.3	0	75	25	2.24	8.7
Hugoton RoyaltyTrust		HGT	6.50	350	2.3	0	88	13	0.46	7.1
<i>Total</i>					20.9		59	41		8.3
<i>CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.</i>										
<i>McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses.</i>										
<i>Present Value (PV) presumes long-term prices of \$100 a barrel for oil and \$6 a million btu for natural gas.</i>										
<i>Dist. = Income distribution. NTM = Next Twelve Months Ended September 30, 2013. Enterprise Value = Market Cap and Debt.</i>										

### A Surprisingly Poor Year in Stock Price for Some Royalty Trusts

The six RTF stocks with the lowest McDep Ratios score year to date 2012 total return ranging from -16% to -64%. Because we have found no reason in most cases to reduce our estimate of present value, the denominator of the McDep Ratio, we conclude that lower ratios mean more future appreciation potential. The two stocks with positive returns for the year share royalty trust



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structural advantages and have active management. DMLP is organized as a master limited partnership, but unlike most MLP's, it has no debt and its distribution reflects actual cash receipts each quarter. While FRHLF is a Canadian corporation, it is primarily a "Top Line" Cash Payer with royalties earned as a percentage of revenue as distinguished from a "Bottom Line" Cash Payer which earns a percentage of profits.

Negative returns in 2012 are further reflected in low ratios in price measures tallied in our weekly valuation tables (see the last table in the series Tables ISC-1 through ISC-4 on pages 5-8). Only FRHLF has positive stock price momentum on a 200-day and 50- day basis.

### **Concentrated 59% on Natural Gas**

Natural gas and oil price may be the most important influence on RTF performance. Quoted at \$3.40 a million btu for November, \$3.80 for the next twelve months and \$4.40 for the next six years, natural gas price is trending upward on a rising 200-day or 40-week basis. Quoted at \$92 a barrel for November, \$93 for the next twelve months and \$90 for the next six years, U.S. oil price is trending downward on a 200-day or 40-week basis. Considering that natural gas is rising from a depressed level the outlook is good, we think, for further natural gas prices gains in the years ahead while remaining a bargain relative to oil. The oil trend may suggest some caution, but the direction can change quickly in an unstable political environment.

### **Cash Accounting Distorts Stock Price Action**

Royalty trusts are committed to distribute monthly the cash received from the oil and gas producing company operating the properties in which the trust has an interest. What that means is if a trust like HGT has a one-time legal settlement, it deducts the value of the settlement from monthly distributions until it is paid. An operating company would simply declare that as a non-recurring item and report earnings as if it had not occurred. A common source of deductions for Bottom Line trusts is capital spending to develop new production. The classic market reaction is that the stock price suffers because current income suffers. In contrast, the long-term value of the trust increases with new drilling. Moreover, simple matters such as adjustments for past overpayments or under payments also contribute to fluctuations in monthly dividends. Finally, there is a lag in payments such that they may reflect actual production from two months to five months earlier. Since stock prices tend to reflect distributions, stock price might continue rising after oil price has peaked or it might be declining after natural gas price has reached bottom. Similarly, when natural gas price is rising, there may be opportunities to buy at lower price until distributions in a few months reflect the higher natural gas price that is already a fact. The balance of cash accounting distortions seems to have been particularly acute in recent months and contributes to our enthusiasm for the RTF idea.

### **U.S. Tax Treatment Facilitates High Income Distributions**

Royalty trust unit holders benefit from the avoidance of double taxation since there is no corporate or trust income tax that must be paid before cash is distributed. That feature makes it



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tax-efficient for the trust to pay more income than a corporation would normally pay. Moreover, a portion of the distribution can be free of tax if it represents a return of capital, which is calculated as cost depletion. Sometimes referred to as the infamous “depletion allowance”, the return of capital is nothing more than the equivalent of depreciation on a real estate property, for example. Moreover, should the trust units be sold for more than their depleted value, depletion previously taken and recovered in the sale is subject to a “recapture” tax. The practical implication for our personal investments is that the core position we expect to keep for years, we hold in a taxable account to benefit from the tax-deferral of depletion. The smaller positions, or those we expect to trade, we hold in a tax-deferred account where the ultimate tax is paid on distributions from the account and not on transactions involving securities in the account.

### **Low Risk Financial, Operating and Reinvestment Features**

There is no risk from financial leverage because royalty trusts carry no debt. Top Line Cash Payers have no significant fixed costs to magnify changes in volume or price. In other words their operating leverage is low. That feature seems to have a noticeable stabilizing effect on distributions and stock price. Bottom Line Cash Payers do have operating leverage. That makes Bottom Line issues especially interesting after a downward fluctuation in volume or price and ahead of a rebound. The last feature, control of reinvestment, offers protection in a period of declining prices or rising costs. Royalty trust unit holders can decide for themselves whether the cash received from oil and gas properties should be reinvested in the same properties or better deployed elsewhere.

### **All RTF Stocks in High Quality Oil and Gas Resources**

HGT: Underlying natural gas properties performing well. Stock depressed by lawsuit settlement that reduces immediate monthly distributions.

MTR: Upside in San Juan Basin. Distribution may be sensitive to Hugoton natural gas liquids price weakness of a few months ago. Recent extra spending on new production depressed distribution.

SJT: Contrarian Buy, valuable San Juan Basin properties with possible Mancos Shale gas upside. Current distributions depressed by recalculation of earlier costs and revenues.

CRT: Top Line San Juan Basin natural gas and West Texas oil, Bottom Line oil. Often inefficiently priced, it seems, in part because of small size.

PBT: Top Line diversified West Texas oil, Bottom Line old, rich oil field on Central Basin Platform of Permian Basin with horizontal and conventional upside beginning to be exploited by operator Conoco Phillips.



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SBR: Only 100% Top Line has many quality properties collected during the late founder's lifetime decades ago. Delivering new volume gains today including Haynesville Shale, Permian Basin Shale and conventional.

DMLP: Contrarian Buy. Top Line volume is rising in Fayetteville, Bakken, Permian and elsewhere. Total return is positive year to date.

NDRO: Year-old royalty trust by son of founder of SJT, PBT and CRT with added feature of commodity hedges that have helped stabilize distributions and stock price.

FRHLF: Canadian corporation profiting from delayed application of fracking to oil fields in Alberta and Saskatchewan. Subject to taxation, some deferred, at corporate level. Dividends to U.S. tax deferred accounts free of Canadian withholding tax. Total return is highest year to date among RTF stocks.

Kurt H. Wulff, CFA



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Table ISC-1											
McDep Income and Small Cap Energy Portfolio											
Debt, Segments, Cash Flow, Income and McDep Ratio											
Symbol/Rating	Price (US\$/sh)		EV/	Enterprise	PV(%)		EV/	Dist.	Dist.		
	B = Buy	4-Oct	Market	Value (\$mm)	Nat	Gas	Ebitda NTM	NTM	Yield (\$/un)	McDep (%)	Ratio
CB (see below)		2012	Cap								
<b>Small Cap Independent Producers</b>											
Peyto Exploration and Developmen	PEYUF		25.38	1.17	4,250	77	23	10.4	0.73	2.9	1.05
PDC Energy	PDCE		32.13	1.71	1,710	54	46	9.9	-	-	1.04
Range Resources	RRC	B	70.57	1.28	14,460	74	26	14.8	0.16	0.2	1.01
Continental Resources (32%)	CLR		76.44	1.19	5,250	25	75	7.6	-	-	0.96
Halcón Resources	HK		7.00	1.37	2,770	12	88	6.6	-	-	0.76
Birchcliff Energy Ltd.	BIREF	CB	7.69	1.45	1,650	63	37	9.8	-	-	0.72
Berry Petroleum Company	BRY		38.96	1.76	3,750	13	87	5.2	-	-	0.69
Denbury Resources Inc.	DNR		16.40	1.49	9,550	6	94	5.8	-	-	0.68
Whiting Petroleum Corporation	WLL	CB	46.60	1.35	7,470	8	92	4.7	-	-	0.60
Cimarex Energy Company	XEC	CB	57.70	1.25	6,230	45	55	5.0	0.48	0.8	0.58
Total or Median					57,100			7.1			0.74
<b>Top Line Cash Payers</b>											
Freehold Royalties Ltd.	FRHLF		20.49	1.04	1,380	16	84		1.71	8.3	0.98
Dorchester Minerals, L.P.	DMLP	CB	22.65	1.00	700	57	43		2.15	9.5	0.84
Sabine Royalty Trust	SBR		51.90	1.00	760	55	45		3.97	7.6	0.80
Permian Basin RT	PBT		15.03	1.00	700	37	63		1.09	7.3	0.75
Cross Timbers Royalty Trust	CRT		31.70	1.00	190	70	30		2.70	8.5	0.72
Total or Median					3,700					8.3	0.80
<b>Bottom Line Cash Payers</b>											
Linn Energy, LLC	LINE		41.65	1.73	14,280	40	60	13.3	2.90	7.0	1.19
Vanguard Natural Resources, LLC	VNR		29.13	1.68	2,560	23	77	10.3	2.40	8.2	1.09
Legacy Reserves L.P.	LGCY		28.74	1.32	1,800	24	76	8.8	2.24	7.8	0.97
Enduro Royalty Trust (40%)	NDRO		18.88	1.00	250	39	61	8.2	1.80	9.5	0.90
Enerplus Corporation	ERF	CB	16.93	1.56	5,200	30	70	6.8	1.10	6.5	0.87
San Juan Basin Royalty Trust	SJT	CB	14.13	1.00	660	100	-	8.8	1.20	8.5	0.67
Mesa RoyaltyTrust	MTR		25.67	1.00	48	75	25	8.6	2.24	8.7	0.64
Hugoton RoyaltyTrust	HGT		6.50	1.00	260	88	13	5.5	0.46	7.1	0.46
Total or Median					25,100			8.7		8.0	0.88
<b>Composite</b>											
Enterprise Value Weighting					85,900	38	62				0.84
Equal Weighting						45	55				0.83
Equal Weighted Buys						49	51				0.76

CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses.

Present Value (PV) presumes long-term prices of \$100 a barrel for oil and \$6 a million btu for natural gas.

Dist. = Income distribution. NTM = Next Twelve Months Ended September 30, 2013. Enterprise Value = Market Cap and Debt.



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Table ISC-2							
<b>McDep Income and Small Cap Energy Portfolio</b>							
<b>Net Present Value and McDep Ratio</b>							
		<i>Price</i> <i>(\$/sh)</i>			<i>Net</i> <i>Market</i> <i>Present</i>	<i>Debt/</i> <i>Present</i> <i>Value</i>	
<i>Symbol/</i> <i>Rating</i>	<i>4-Oct</i> <i>2012</i>	<i>Shares</i> <i>(mm)</i>	<i>Cap</i> <i>(\$mm)</i>	<i>Value</i> <i>(\$/un)</i>			<i>McDep</i> <i>Ratio</i>
<b>Small Cap Independent Producers</b>							
Peyto Exploration and Development Cor	PEYUF	25.38	143.1	3,630	24.00	0.15	1.05
PDC Energy	PDCE	32.13	31.0	1,000	30.00	0.43	1.04
Range Resources	RRC	B	70.57	160.0	11,290	70.00	0.22
Continental Resources (32%)	CLR	76.44	57.6	4,400	80.00	0.16	0.96
Halcón Resources	HK	7.00	290.0	2,030	10.00	0.20	0.76
Birchcliff Energy Ltd.	BIREF	CB	7.69	148.0	1,140	12.00	0.22
Berry Petroleum Company	BRY	38.96	54.7	2,130	70.00	0.30	0.69
Denbury Resources Inc.	DNR	16.40	391.0	6,410	28.00	0.22	0.68
Whiting Petroleum Corporation	WLL	CB	46.60	119.0	5,550	88.00	0.16
Cimarex Energy Company	XEC	CB	57.70	86.4	4,990	110.00	0.12
<i>Total or Median</i>				42,570		0.21	0.74
<b>Top Line Cash Payers</b>							
Freehold Royalties Ltd.	FRHLF	20.49	64.7	1,330	21.00	0.04	0.98
Dorchester Minerals, L.P.	DMLP	CB	22.65	30.7	700	27.00	-
Sabine Royalty Trust	SBR	51.90	14.6	760	65.00	-	0.80
Permian Basin RT	PBT	15.03	46.6	700	20.00	-	0.75
Cross Timbers Royalty Trust	CRT	31.70	6.0	190	44.00	-	0.72
<i>Total or Median</i>				3,680			0.80
<b>Bottom Line Cash Payers</b>							
Linn Energy, LLC	LINE	41.65	198.0	8,250	30.00	0.50	1.19
Vanguard Natural Resources, LLC	VNR	29.13	52.2	1,520	25.00	0.44	1.09
Legacy Reserves L.P.	LGCY	28.74	47.5	1,370	30.00	0.23	0.97
Enduro Royalty Trust (40%)	NDRO	18.88	13.2	250	21.00	-	0.90
Enerplus Corporation	ERF	CB	16.93	196.0	3,320	21.00	0.31
San Juan Basin Royalty Trust	SJT	CB	14.13	46.6	660	21.00	-
Mesa RoyaltyTrust	MTR	25.67	1.9	48	40.00	-	0.64
Hugoton RoyaltyTrust	HGT	6.50	40.0	260	14.00	-	0.46
<i>Total or Median</i>				15,680			0.88

B=Buy; CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

Present Value presumes long-term prices of \$100 a barrel for oil and \$6 a million btu for natural gas.



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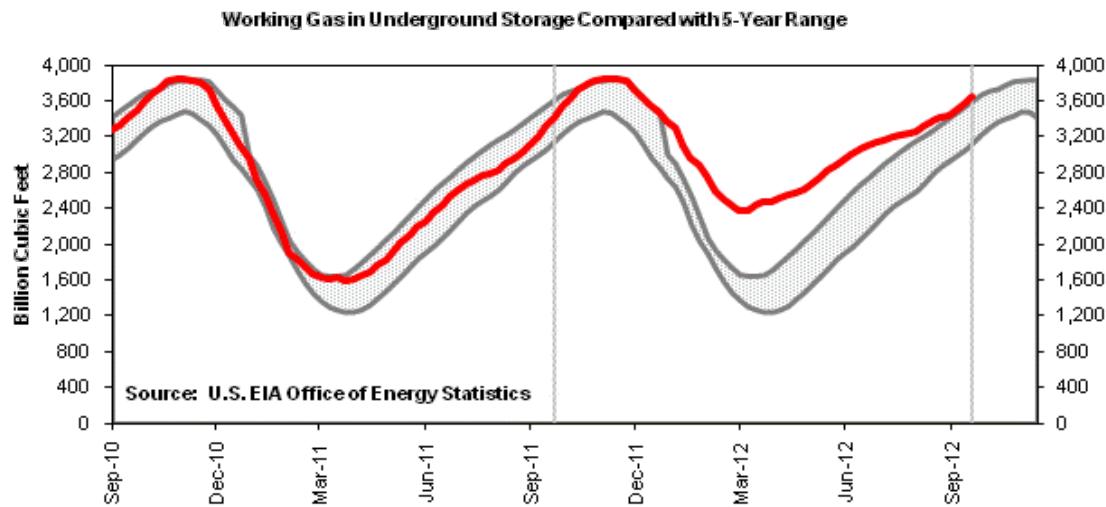
Table ISC-3							
McDep Income and Small Cap Energy Portfolio							
Value Multiples - Rank by EV/Ebitda							
		Price (\$/sh)	Revenue	Adjstd Resrvs/	PV/	EV/	
Symbol/ Rating		4-Oct 2012	Royalty (%)	Dist/ Ebitda	Prod NTM	Ebitda NTM	Ebitda NTM
<b>Small Cap Independent Producers</b>							
Range Resources	RRC	B	70.57	-	14.7	14.7	14.8
Peyto Exploration and Development Corp	PEYUF		25.38	0.30	9.1	9.9	10.4
PDC Energy	PDCE		32.13	-	8.6	9.5	9.9
Birchcliff Energy Ltd.	BIREF	CB	7.69	-	20.9	13.6	9.8
Continental Resources (32%)	CLR		76.44	-	10.1	7.9	7.6
Halcón Resources	HK		7.00	-	5.6	8.7	6.6
Denbury Resources Inc.	DNR		16.40	-	13.0	8.5	5.8
Berry Petroleum Company	BRY		38.96	-	11.4	7.5	5.2
Cimarex Energy Company	XEC	CB	57.70	-	7.7	8.6	5.0
Whiting Petroleum Corporation	WLL	CB	46.60	-	9.3	7.8	4.7
<i>Median</i>					9.7	8.6	7.1
<b>Top Line Cash Payers</b>							
Sabine Royalty Trust	SBR		51.90	100	1.00	7.9	16.4
Freehold Royalties Ltd.	FRHLF		20.49	71	0.97	5.6	11.9
Cross Timbers Royalty Trust	CRT		31.70	78	0.96	17.9	15.7
Dorchester Minerals, L.P.	DMLP	CB	22.65	77	1.00	6.4	12.6
Permian Basin RT	PBT		15.03	47	0.73	9.4	13.4
<i>Median</i>					7.9	13.4	11.3
<b>Bottom Line Cash Payers</b>							
Linn Energy, LLC	LINE		41.65		1.07	15.1	11.1
Vanguard Natural Resources, LLC	VNR		29.13		0.91	14.0	9.5
Legacy Reserves L.P.	LGCY		28.74		0.68	11.4	9.1
San Juan Basin Royalty Trust	SJT	CB	14.13		0.75	8.6	13.1
Mesa RoyaltyTrust	MTR		25.67		0.75	7.7	13.4
Enduro Royalty Trust (40%)	NDRO		18.88		0.78	7.2	9.1
Enerplus Corporation	ERF	CB	16.93		0.41	6.3	7.8
Hugoton RoyaltyTrust	HGT		6.50		0.39	13.4	11.8
<i>Median</i>					10.0	10.3	8.7
B=Buy; CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average. EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended September 30, 2013; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses Top Line Cash Payers defined as those having Revenue Royalty (see fifth column from right).							



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Table ISC-4							
Oil and Gas Income and Small Cap Stocks							
Rank by Enterprise Value to 200 Day Average							
		Price (\$/sh)				Enterprise Value/ 200 Day Avg.	
Symbol/ Rating		4-Oct 2012	52Wk High	52Wk Low	50 Day Avg.	200 Day Avg.	McDep Ratio
<b>Small Cap Independent Producers</b>							
Peyto Exploration and Development Corp.	PEYUF	25.38	0.99	1.57	1.13	1.25	1.05
Range Resources	RRC	B	70.57	0.95	1.25	1.04	1.10
PDC Energy	PDCE		32.13	0.87	1.45	1.07	1.03
Continental Resources (32%)	CLR		76.44	0.81	1.59	1.03	1.00
Denbury Resources Inc.	DNR		16.40	0.83	1.34	1.02	0.98
Whiting Petroleum Corporation	WLL	CB	46.60	0.78	1.39	1.02	0.97
Berry Petroleum Company	BRY		38.96	0.79	1.14	1.00	0.95
Birchcliff Energy Ltd.	BIREF	CB	7.69	0.59	1.33	1.08	0.94
Cimarex Energy Company	XEC	CB	57.70	0.71	1.19	0.98	0.93
Halcón Resources	HK		7.00	0.60		0.95	0.76
<i>Median</i>				0.80	1.34	1.02	0.98
<b>Top Line Cash Payers</b>							
Freehold Royalties Ltd.	FRHLF		20.49	0.97	1.47	1.04	1.06
Dorchester Minerals, L.P.	DMLP	CB	22.65	0.85	1.14	1.02	0.99
Sabine Royalty Trust	SBR		51.90	0.77	1.14	0.98	0.92
Cross Timbers Royalty Trust	CRT		31.70	0.62	1.05	0.88	0.79
Permian Basin RT	PBT		15.03	0.65	1.04	0.89	0.78
<i>Median</i>				0.77	1.14	0.98	0.92
<b>Bottom Line Cash Payers</b>							
Linn Energy, LLC	LINE		41.65	1.00	1.17	1.03	1.05
Vanguard Natural Resources, LLC	VNR		29.13	0.99	1.17	1.02	1.04
Legacy Reserves L.P.	LGCY		28.74	0.95	1.17	1.03	1.03
Enerplus Corporation	ERF	CB	16.93	0.69	1.27	1.05	0.95
San Juan Basin Royalty Trust	SJT	CB	14.13	0.56	1.17	0.97	0.83
Mesa RoyaltyTrust	MTR		25.67	0.57	1.12	0.97	0.76
Hugoton RoyaltyTrust	HGT		6.50	0.29	1.14	0.95	0.58
<i>Median</i>				0.69	1.17	1.02	0.95
CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.							

  
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**Research Methodology/Ratings Description:** McDep LLC is an independent research originator focused on oil and gas stocks exclusively. The firm applies the forty years of experience of its analyst to estimate a present value of the oil and gas resources and other businesses of covered companies. That value is compared with a company's stock market capitalization and debt. Stocks with low market cap and debt relative to present value tend to outperform stocks with high market cap and debt relative to present value. Buy recommendations are expected to deliver a total return better than 7% per year above inflation. Hold recommendations assume the attributes of the underlying business are reflected in the current price of the stock. Sell recommendations are expected to deliver a total return less than inflation.